APPLICATION OF

ROANOKE GAS COMPANY **CASE NO. PUE960304**

For expedited rate relief

and

APPLICATION OF

ROANOKE GAS COMPANY **CASE NO. PUE960102**

For an Annual Informational Filing

REPORT OF DEBORAH V. ELLENBERG, CHIEF HEARING EXAMINER

April 30, 1998

On July 9, 1996, Roanoke Gas Company (“Roanoke” or the "Company") submitted its completed Annual Informational Filing ("AIF") for the twelve month period ending March 31, 1996. On October 25, 1996, after analyzing the Company's financial data, the Staff filed a report in which it concluded that, based on the results of a per books earnings test, Roanoke earned well above the authorized range for its return on equity for the test period. The authorized return on equity was 11.2% to 12.2%. Staff found the earned return to be 14.723% after limited adjustments. (Ex. JBW-5, Att. 1, at 5-7). Staff determined that the earnings were thus sufficient to recover the unamortized balances of rate case expenses, depreciation study costs, franchise costs, liquefied natural gas (“LNG”) tank painting costs, union negotiation costs, union organization costs, and early retirement costs associated with personnel. Staff, therefore, concluded that those regulatory assets should not be included in any future filings. (Id.).

The Company objected to Staff’s use of an earnings test. It further asserted that if an earnings test was to be used, the revenue in the analysis should be weather normalized. By motion dated November 27, 1996, the Company asked the Commission to defer ruling on the issues raised by Staff in its 1996 AIF, and requested that the AIF be consolidated for hearing with an expedited rate application that it intended to file in December 1996.

On December 2, 1996, Roanoke filed an expedited rate application and on December 10, 1996, the Commission consolidated the issues raised by the Staff in the 1996 AIF for hearing with the rate case. In its application for rate relief, the Company sought an increase in its gross annual

revenues of $959,277.[1] The Company provided data for the twelve months ending September 30, 1996 in support of its request. On December 19, 1996, the Commission authorized Roanoke to implement the proposed increase on an interim basis, subject to refund with interest, for service rendered on and after January 1, 1997.

The hearing on the consolidated filings was convened on June 25, 1997. Michael J. Quinan, Esquire, and Donald D. Long, Esquire, appeared on behalf of the Company. Sherry H. Bridewell, Esquire, and C. Meade Browder, Jr., Esquire, appeared on behalf of the Commission Staff. Proof of notice was marked as Exhibit A and admitted into the record. A transcript of the hearing is filed with this report.

On August 8, 1997, Staff and the Company filed simultaneous briefs.

SUMMARY OF THE RECORD

Roanoke distributes natural gas to approximately 47,000 residential, commercial and industrial customers primarily within the Cities of Roanoke and Salem, and the Counties of Roanoke, Botetourt and Montgomery. In support of its request for an increase in annual revenues of $959,277, the Company presented the testimony of Frank Farmer, J. David Anderson, Art Pendleton and John Williamson, III. Its application is based on a test period ending September 30, 1996. The Company based its request on a cost of equity of 11.7%, the midpoint of the previously approved range of 11.2% to 12.2%.

Staff presented the testimony of Scott Armstrong, Mary E. Owens, and John Stevens. Staff updated revenues, rate base and related items to provide a more current view of the Company's financial requirements and concluded that Roanoke was entitled to an increase in revenues of no more than $236,110. That requirement was based on the midpoint of Staff's recommended overall cost of capital range of 9.450% to 9.877%. (Exs. SCA-14; MEO-16, at 19-20; and Tr. 9). Staff's recommended cost of equity is in the range of 10.7% to 11.7%. (Id.).

The Company and Staff agreed on a number of issues. The Company has accepted Staff's updated capital structure, and cost of long- and short-term debt. The Company also accepted Staff's updated accounting adjustments to rate base and revenue except as noted in its rebuttal testimony. The Company agreed to Staff's payroll adjustment. Specifically, Staff removed a proposed increase to the Company's payroll expense which was based upon an anticipated labor contract renegotiation. The Company believes that the requested increase of 2.5% is reasonable, but negotiations had not progressed far enough to give the Commission firm and certain data; therefore, the Company was willing to forego recognition of that expense. The Company also agreed to accept Staff witness Stevens' recommendations with regard to rate design and revenue apportionment. (Exs. JAS-11; JBW-6, at 1-2). Agreement on the cost of service study methodology and allocation factors to be applied was also reached. After reaching agreement on those several adjustments, the Company revised its requested increase to $602,499. (Tr. 19).

[1]During the hearing, the Company reduced its requested increase to $602,499. (Tr. 19).

The Company and Staff, however, continued to disagree on a number of issues which have a substantial impact on Roanoke's revenue requirement. Most notably, they disagree on the application of an earnings test to the twelve months reviewed in the AIF and again to the test period for the rate case. The AIF review period ended March 31, 1996. The test period for the rate case ended September 30, 1996. As a result of its analyses, Staff proposes to consider a number of previously approved regulatory assets as recovered earlier than had been anticipated. Many of the issues related to application of the earnings test in this case have not been previously addressed by the Commission, and thus, are significant in terms of the impact on Roanoke and also in establishing precedent for similarly situated companies.

Other issues which continued to be in controversy in this case included treatment of certain accruals for nonproductive pay liability, cooperative advertising, rate base related to certain office space, and the cost of equity. More specifically, the Company booked catch-up accruals for nonproductive personnel costs such as vacation and sick leave. The accruals ended at the end of the 1996 calendar year, three months into the pro forma period and will not recur in the rate year beginning January 1, 1997. Staff removed the accrual amount because it did not extend into the rate year. The Company asserts that a proportional allowance for the expense is warranted in an expedited case.

Staff also considered evidence presented by the Company on certain advertisement expenses. Staff excluded advertising costs which it believes offer no benefit to the public interest, including certain promotional expenses.

Staff disallowed a portion of rate base attributable to the Gas Information Center. This Center contains a number of brochures from manufacturers dealing with furnaces and hot water heaters fueled by natural gas. Staff concluded that Roanoke's ratepayers should not bear the cost of allowing vendors to advertise in Roanoke's office. Therefore, Staff proposes to remove a portion of the cost of the office space from Roanoke's rate base. The Company argues that it does not sell appliances at all. The Center, it asserts, simply provides an information service to customers which they expect when they come to pay their bills.

Staff also made several booking recommendations which the Company accepted. Finally, Staff recommends a cost of equity within the range of 10.7% to 11.7%. Roanoke accepted Staff's method of calculating its cost of equity but challenged the proxy group which Staff used in its calculation. Roanoke requests a 50 basis point risk premium to adjust for the difference in risk between it and the proxy group companies.

DISCUSSION

Earnings Test

The first and most significant series of contested issues relates to Staff's application of an earnings test. An earnings test is a per books measurement of historic earnings based on average rate base and investment. Adjustments are made to restate the per books data to a regulatory basis, but the purpose of the test is to review historic earnings not to set future rates. In this case, Staff proposes to analyze the Company's earnings for both the year ending March 31, 1996, which was

reviewed in the Company's AIF and the test period for the rate case ending September 30, 1996. Staff first conducted an analysis of the Company's AIF test period earnings, and concluded that the Company had earned in excess of its authorized return on common equity during that time. After adjustments, the earnings test reflected a return on equity of 14.723%. The authorized range during that period was 11.2% to 12.2%. Staff recommended that regulatory assets totaling $438,803 be considered recovered during that twelve months ending March 31, 1996. (Ex. SCA-12, at 22 and Statement VI). The regulatory assets on the Company's books and the expected deferral periods are: rate case expenses (3 years), costs of a depreciation study (5 years), franchise costs (5 years), LNG tank painting costs (5 years), union contract negotiation costs (3 years), union organization costs (3 years), early retirement costs (3 years), and SFAS 106 implementation costs (3 years). (Id.).

Staff also analyzed the Company's earnings for the twelve months ending September 30, 1996, the test year in the rate application. That earnings test showed that the Company was earning a per books return on average equity of 11.355%, just above the bottom of the authorized range of 11.2% to 12.2%. (Id. at 23). Staff's earnings test for the test period for the rate case includes an adjustment to remove half the amount of the regulatory assets considered recovered during the AIF review period. Staff asserts that such an adjustment is necessary to avoid overstating current period excess earnings since the test period for the AIF and that for the rate case overlap six months. Staff concludes that $66,259 of the $150,422 of deferred costs associated with the removal of a retired gas manufacturing plant should be considered recovered during the test period for the rate case, since in Staff's opinion, only the unamortized costs which reduce earnings below the authorized range should continue to be allowed in cost of service when setting rates for the future. (Exs. SCA-12, at 24; SCA-14, Statement V-A). Staff does not challenge the reasonableness of any of the regulatory assets at issue.

The Company asserts that use of an earnings test as proposed by Staff is unlawful, unfair and generally problematic. The Company asserts that use of an earnings test as recommended by Staff (1) constitutes retroactive ratemaking, (2) fails to provide a fair opportunity to recover regulatory assets, (3) denies companies the right to retain earnings that fall within their authorized range of return, (4) discriminates against and punishes companies with regulatory assets, and (5) since it is not performed on a fully adjusted basis, does not reflect actual performance. Moreover, the Company argues that Staff's application of the test in this case is unfair because it requires acceleration of the recovery of regulatory assets when earnings are high but will not extend the recovery period when earnings are low. Although opposing the use of an earnings test to judge the recovery of previously approved regulatory assets, the Company also asserts that if the Commission approves such a test, it should be weather normalized.

In this case, the Company also asserts that the Staff has applied the earnings test without properly recognizing that the test periods overlap. The Company argues that the Staff uses the same earnings twice to judge the recovery of regulatory assets.

A regulatory asset is a deferral of a current period cost which is amortized over an extended period of time for ratemaking. Regulatory approval of the recovery of the deferred cost is necessary in order for a company to record a regulatory asset in compliance with the provisions of the Statement of Financial Accounting Standards ("SFAS"). A regulatory asset may initially be established with the approval of the Director of Public Utility Accounting, and often the Commission

approves the deferral and amortization in a rate case. Generally, a prudently incurred cost may be deferred for future recognition only when a company incurs an unusually large or nonrecurring cost that causes financial results to be materially and negatively affected by currently expensing the cost. Such deferrals allow a regulated company to recover extraordinary expenses from ratepayers over extended periods. A regulatory asset thus is an effective sharing mechanism providing some degree of rate stability and protection for the ratepayer and an opportunity to recover extraordinary but reasonable costs for the company. However, as the Commission found in a 1996 rate case, "deferral of any costs is unusual and should be allowed for ratemaking purposes only rarely and in extreme situations." *Application of Appalachian Power Company*, Case No. PUE940063, 1996 S.C.C. Ann. Rep. 255, 257. Many costs subject to deferral could have been excluded as nonrecurring, but if they were incurred in good faith, the Commission may choose to allow a sharing between the company and its ratepayers.

Booking regulatory assets thus allows a company the opportunity to recover extraordinary costs, but is not a guarantee of recovery. There, of course, are very few guarantees in ratemaking, and certainly the Commission never intended to assure the recovery of specific dollar amounts of any regulatory asset. When dollar for dollar recovery is intended, the Commission has specifically and clearly established an appropriate mechanism. It is noteworthy that in an unregulated environment, a company does not book regulatory assets, and would expense similar costs during the period in which they were incurred.

The Commission has considered and applied earnings tests on several occasions. The Commission addressed the issue of deferred capacity expenses and the use of an earnings test in *Ex Parte: In the matter of establishing Commission policy regarding rate treatment of purchased power capacity charges by electric utilities and cooperatives*, Case No. PUE880052, 1988 S.C.C. Ann. Rep. 346. The Final Order adopting policy in that case stated, "[t]he Staff will conduct an earnings test and validate the capacity recovery. As a result of this procedure, the Commission can determine whether the capacity costs are subject to future recovery." (Id. at 348).

In the first relevant application of an earnings test following that policy determination, recovery of deferred capacity charges was evaluated based on Virginia Power's earnings in 1987. *Application of Virginia Electric and Power Company*, Case No. PUE880014, 1988 S.C.C. Ann. Rep. 312, 314. It should be noted that at that time capacity charges were increasing rapidly as a result of significant third party generation coming on line, thus representing an extraordinary cost which could have had a very significant financial impact on the company. In that case the Hearing Examiner concluded that the query should focus on actual operating results for 1987, not hypothetical future results generated from fully adjusted 1987 test year data. (Report of Glenn P. Richardson at 11 (November 10, 1988)). The Hearing Examiner noted that the traditional ratemaking analysis for setting future rates is simply not a reliable measure of past earnings. (Id. at 29).

> The only reliable method available to test historic 1987 earnings is actual 'per book' operating results adjusted for: 1) restatements from GAAP to regulatory accounting, 2) removal of out-of-period expense and revenue items, 3) inclusion of JDC capital expense and

> associated tax savings, and 4) use of average investment to measure earnings.

Id.

In a later case, the Commission abandoned the earnings test for Virginia Power. *Application of Virginia Electric and Power Company*, Case No. PUE910047, 1992 S.C.C. Ann. Rep. 291. There, Staff urged the Commission to move away from an earnings test. The Commission moved back to base rate recovery but directed the Company to account for all capacity charges in between rate cases to facilitate dollar for dollar recovery of reasonably incurred capacity costs. (Id. at 293).

The earnings test again was used in the ratemaking process when accounting for changes for certain postretirement benefits, SFAS 106. The Commission reviewed SFAS 106 in *Ex Parte, In re: Consideration of a rule governing Accounting for Postretirement Benefits other than Pensions*, Case No. PUE920003, 1992 S.C.C. Ann. Rep. 315. The Final Order in that case states:

> Finally, we also agree that utilities which will not adjust rates coincident with implementation of the SFAS 106 accrual may defer the difference between accrual of OPEB expenses for reporting and ratemaking purposes as a regulatory asset upon two conditions. Such deferral will only be available if the company is earning below its authorized range of return on equity and will file for a change in rates within two years of implementing SFAS 106 or two years of this order, whichever is later. The earnings test period should coincide with the period the accrual is being booked.

Id. at 316.

Staff's position on the recovery of regulatory assets in this case is not conceptually new to the Company. Staff first announced its intent to apply an earnings test to all regulatory assets in a letter dated March 29, 1995, issued by the Commission's Director of Public Utility Accounting. The letter clearly sets forth Staff's position on the subject of regulatory assets. (Ex. SCA-15). Therein Mr. Gibson advised all utilities that the earnings test will be based on per books, Virginia jurisdictional results, however:

> [l]imited adjustments should be made in order to restate books to a ratemaking basis and to determine earnings relative to average investment. Adjustments to reflect normal weather would not be appropriate for the earnings test. Furthermore, in the context of AIF's or rate filings in future years, unamortized balances of regulatory assets will be subject to full or partial write-off in the event an overearnings situation develops.

Id. at 2.

Mr. Gibson was concerned that in an increasingly competitive environment, utilities should reevaluate using any type of deferral mechanism.

The Commission addressed an earnings test most recently in a rate case for *Appalachian Power Company*, Case No. PUE940063, 1996 S.C.C. Ann. Rep. 255, to determine whether that company could establish a regulatory asset related to storm damage. There, the Commission held that:

> First, deferral of any costs is unusual and should be allowed for ratemaking purposes only rarely and in extreme situations. Second, where deferral is allowed, no costs the Company has actually recovered should be deferred. . . . If the Company recovered all or part of those expenses in the test year then those recovered expenses cannot be deferred and recovered again. The issue is simple. . . We determine the degree to which the storm damage expenses have been recovered with an earnings test.

Id. at 257.

That case assessed whether and to what extent a regulatory asset should be created, but the Commission has also approved use of a test period earnings test to evaluate the recovery of previously approved regulatory assets in several other cases, all of which involved settlements or stipulations by the companies. *Application of Washington Gas Light Company*, Case Nos. PUE950006 and PUE960042, 1996 S.C.C. Ann. Rep. 262; *Application of Southwestern Virginia Gas Company*, Case No. PUE960028, 1996 S.C.C. Ann. Rep. 307; and *Application of Shenandoah Gas Company*, Case No. PUE960068, 1996 S.C.C. Ann. Rep. 311.

In the pending case the Staff uses an earnings test to determine whether certain regulatory assets created in prior cases have been recovered on an accelerated basis. This proceeding thus represents the first contested case in which Staff proposes to consider a previously approved regulatory asset as recovered prior to the end of the expected deferral period.

Use of an earnings test does not constitute retroactive ratemaking.

The Company first asserts that Staff's use of a past earnings test constitutes retroactive ratemaking. Retroactive ratemaking has been narrowly construed in Virginia to occur only when retroactive increases or decreases are ordered to depart from previously approved Commission rates. The Commission, for instance, cannot impose a retroactive rate increase to make up for any past deficiency in earnings. *Vepco v. State Corporation Commission*, 226 Va. 541, 549 (1984). Similarly, the Commission cannot "go back in time to order refunds of revenues collected under [excessive] rates that were legally in effect at the time the revenues were collected." *Commonwealth Gas Pipeline v. Anheuser-Busch*, 233 Va. 396, 402 (1987). Rates which are legally established by the Commission are conclusively presumed to be reasonable until changed by the Commission in the manner prescribed by law. *Commonwealth v. Old Dominion Power Company*, 184 Va. 6, 17 (1945). Clearly, revisions in rates can only operate prospectively, and to do otherwise would constitute retroactive ratemaking.

Use of an earnings test to determine if previously authorized regulatory assets have been recovered does not constitute retroactive ratemaking as narrowly construed in the cases cited above.

Staff does not propose to retroactively change the Company's rates that were in effect during the prior periods. Prior rates will not be altered and no refunds are recommended as a result of the Staff's recommendations on regulatory assets.

The legislative nature of ratemaking, in fact, makes it incumbent upon the Commission to regularly reevaluate a company's expenses. If the Commission finds that a change in the amortization period of an expense is appropriate, it should order appropriate adjustments.

A test used to measure actual historic earnings should be adjusted only as necessary to restate books to a regulatory basis.

Staff recommends that certain adjustments should be made before the earnings test is conducted to judge the recovery of regulatory assets. I agree. The per books financial data in an earnings test should be adjusted to restate books to a regulatory basis, to remove out of period expenses and revenues, to include job development credit ("JDC") capital expense and associated tax savings, and to use average, not year-end investment. An earnings test, however, should not evolve into a fully adjusted rate case within a rate case.

Although the Company opposed an earnings test, it also noted that if the Commission decided to apply the test, it should be weather normalized. Yet, the purpose of an earnings test is to judge actual earnings during the test period, therefore actual earnings must serve as the focus. While it is important to weather normalize revenues of a historic period when setting rates for the future because it is impossible to forecast weather for a future period with any certainty, there is no need to adjust for normal weather when your purpose is to review historic earnings. We know with absolute certainty what the weather was yesterday. Moreover, such an adjustment is inappropriate for most regulatory assets because "normal" weather does not occur over the short term. (Ex. SCA-12, at 22). Weather normalizing a historic period will distort the Company's actual earnings for that test period and will not yield an accurate picture of historic earnings. I agree with Staff that the earnings test to judge the recovery of a regulatory asset should not be weather normalized.

Deferred costs in this case should be considered recovered only when Company earnings exceed the authorized return of equity range.

Staff and the Company also disagree on how much should be considered recovered if the earnings test is applied and the Company is found to be overearning. The Company asserts that it should only be required to write off assets to the top of the range and the Staff asserts that assets should be considered recovered if earnings still fall anywhere above the bottom of the authorized return on equity range.

The Commission has addressed the issue of whether a range or a point should be used in an evaluation of whether a company has earned a reasonable return on its equity. The Commission has found that:

> the range, not the point, is the proper mark. The Commission's determination of a reasonable range of return on equity is made in a general rate case after hearing expert testimony on the subject, all of

> which is generally expressed in the form of a range, or band, given the admittedly imprecise nature of the judgments and analyses involved. When the Commission adopts a range, its finding simply reflects that the utility has the need, and right, to an opportunity to earn a return on equity somewhere within that range. Future earnings anywhere within that range will be lawful, and will be considered neither excessive nor insufficient.
>
> . . . .
>
> the only real necessity for picking an exact point within the range is so that precise tariff rates can be calculated. Fixing such a point is thus a far less important part of the ratemaking process than determining the range itself.

Application of Virginia Electric and Power Company, Case No. PUE880014, 1988 S.C.C. Ann. Rep. 312, 314.

The Commission went on to note that "[t]he fact that the Company did not actually earn [its authorized return] on equity during the test year has no bearing on this issue. It is only entitled to the opportunity to earn. . . its lawfully approved range." (Id. at 315).

The Commission, as noted earlier, applied the earnings test to determine whether Appalachian Power Company should be allowed to defer costs associated with extraordinary storm damage. *Application of Appalachian Power Company*, Case No. PUE940063, 1996 S.C.C. Ann. Rep. 255, 257 ("APCO case"). There, the Commission allowed deferral and recovery of only that portion of the costs that would have caused earnings to fall below the bottom of the authorized range. The Commission reasoned that earnings above the bottom of the range were reasonable. (Id.).

This case is different, however, since the Commission is not asked to take the unusual step of determining whether and to what extent a regulatory asset should be created; rather, the Commission is asked to take the equally unusual step of determining whether and to what extent previously approved regulatory assets should be considered recovered earlier than anticipated. Under an earnings test, if the Company's test period earnings are found to be within the authorized range, the earnings should be considered reasonable and neither excessive nor deficient. Certainly a write-off to the bottom of the range would still allow the Company's test period earnings to fall within the range found to be reasonable, but similarly, the Company's earnings would be within the range found reasonable at the top of the range. Unusual actions to defer costs actually incurred, i.e., create regulatory assets, or alter previously established amortization schedules should not be undertaken as long as earnings fall within this range of reasonableness. Therefore, as the Commission found in the APCO case, a regulatory asset should only be created if current expensing of an extraordinary but prudently incurred cost would cause a company's earnings to fall below the authorized range. Similarly, if a company is found to be overearning, the fair and more balanced position, in my opinion, would be to direct the Company to treat regulatory assets as already recovered only with

excessive earnings or to the top of the authorized range. Hence, earnings anywhere within the range would be considered reasonable.

The Staff's earnings test reveals that the Company was over-earning during the review period ending March 31, 1996, for the AIF. (Ex. SCA-12, Schedule VI). Staff's Earnings Test Statement is attached hereto as Attachment A for easy reference. I agree that it is appropriate to consider regulatory assets as recovered during that period. After reflecting the recovery of the Company's regulatory assets, Roanoke's earnings were still above the authorized range for a reasonable return on equity. After adjustments, the Company still earned a return on equity of 12.791%, compared to the approved range of 11.2% to 12.2%.

Moreover, although I also agree that an earnings test should be conducted for the test period in the rate case, I disagree with Staff's conclusion that regulatory assets should be recognized as recovered as long as earnings still fall above the bottom of the range. Staff's Earnings Test Statement for that period is attached hereto as Attachment B. (Ex. SCA-14, Schedule V-A). Since the Company's earnings fall within the range for a reasonable return on equity, no further adjustments should be made to account for accelerated recovery of regulatory assets during the test period ending September 30, 1996. Attachment C to this Report reflects revisions to Staff's Earnings Test Statement for the year ending September 30, 1996 to show no additional write-off during that period. The Statement shows that the Company's 11.489% return on equity is well within the authorized range.

Unless otherwise specifically provided for at the inception of a regulatory asset, only excess earnings should be used to reflect accelerated recovery. Contrary to Staff's recommendation to reflect the early recovery of regulatory assets to the bottom of the range, recovery of such assets should only be reflected to the top of the authorized range. Such a sharing is, in my opinion, more consistent with the Commission's policy of treating earnings anywhere within the range as lawful, and neither excessive nor insufficient.

Finally, as Mr. Gibson indicated in his letter to all utilities, we should try to move away from artificial regulatory mechanisms as we move towards a competitive environment. The ratepayers and stockholders of tomorrow will not benefit from continuing to have costs from past periods on the company's books. It makes far more sense to remove those regulatory assets from the books during periods of excess, or above authorized earnings, and thus allow companies to be better postured to compete in a new environment.

Staff's application of the earnings test to the Company's AIF and the rate case test periods is proper.

If the Commission determines that regulatory assets should be considered recovered to the bottom of the range whether or not a company is earning within its authorized range, one other issue related to application of the earnings test must be considered. The Company asserts that Staff improperly considered earnings twice when it conducted the test for the rate case test period. The test periods for the AIF and the rate case overlap by six months.

The Company asserts that most of its earnings during the rate case test period occurred during the six months common to both review periods. (Ex. JBW-6, at 25). Mr. Williamson

presented monthly reports of income in his rebuttal testimony and argues that Staff double counted those earnings. Staff countered that rates are established and evaluated on a full twelve months without regard to summer underearnings or winter overearnings. (Tr. 108). Further, Staff points to several problems with the data presented by Mr. Williamson. Staff points out that the month- by-month analysis provided by Mr. Williamson reports net unadjusted income. It reflects no regulatory adjustments, does not use a 13-month average rate base, and includes nonregulated revenues and expenses. (Tr. 73-74). Overlapping test periods are problematic for gas companies; however, Roanoke chose the test period for its rate case. Moreover, although I recognize that natural gas company revenues significantly fluctuate on a seasonal basis and consequently, most of the revenue was received during the overlapping months, the record does not support, nor do I believe it would be prudent to support, a monthly earnings analysis. In this case, earnings should be evaluated on a twelve-month basis despite the overlapping test periods.

4. Nonproductive pay liability

Staff witness Armstrong proposes to eliminate $76,034 attributable to a catch-up accrual which Roanoke was required to make to reflect nonproductive liability for vacation and sick leave at an appropriate level. The accruals were placed on the Company's books several years ago to properly reflect the ongoing level of such cost. The accrual was booked over a three year period ending December 31, 1996. (Ex. SCA-12, at 12 and SCA-13, at 4-5). The test period ends September 30, 1996, thus the accruals continued through the test year and into the pro forma period for three months. Rates were placed into effect January 1, 1997, hence the accrual did not continue into the rate year. The Company asserts that since the accruals were in effect for three months of the pro forma year, the Company should be allowed an expense which recognizes a level equal to one-quarter of the full test year amount. Staff, however, proposes to eliminate the expense completely because the accruals ended before the rate year began. (Exs. JDW-6, at 10; SCA-13, at 4-5).

The Company cites the Rate Case Rules at Schedule 14, Section 1.b., which specifically provide that: "Proforma adjustments will be limited in expedited cases to the amount of increase or decrease that will be in effect during the proforma period. . ." Accordingly, the Company argues that an adjustment to a pro forma period level is appropriate in an expedited case. The Company further asserts that the expense at issue is appropriate for adjustment because the Company will continue to incur nonproductive personnel costs during the rate year. Thus, Roanoke argues that nonproductive liability pay is different than the case in which Virginia Power was denied a pro forma period adjustment in an expedited case for an amortization expense for leased turbines when it was not going to incur any leased turbine expense during the rate year. *Application of Virginia Electric and Power Company*, Case No. PUE910047, Report of Glenn P. Richardson at 40 (October 23, 1992).

However, the Company does concede that the accrual itself will not continue into the rate year and was eliminated on December 31, 1996. (Tr. at 44-45). In the Virginia Power case, the Hearing Examiner found that "[o]bviously, the limitations contained in the Rate Case Rules cannot be manipulated in such a manner as to allow the recovery of costs which no longer exist. The Company will not incur any leased turbine expense during the rate year, and it would be improper to require ratepayers to fund a non-existent expense through rates." The Commission agreed. *Application of Virginia Electric and Power Company*, Case No. PUE910047, 1992 S.C.C. Ann. Rep. 291, 292. Here, I am not persuaded that Roanoke's adjustment should be allowed. The Staff

includes an ongoing level of nonproductive pay liability. It is only the catch-up accrual at issue. As in the Virginia Power case, the accrual has ended and consequently, should not be included in rates designed for the future.

5. Cooperative advertising

Staff removed $13,289 in cooperative advertising expenses because the expenditures have not been demonstrated to promote the public interest and rather, appear to promote load growth. (Exs. JBW-6, at 3; and Tr. at 98). The advertisements which Staff reviewed focused on newly constructed homes, did not identify energy savings appliances or energy efficiencies in the homes featured in the advertisements, and did not identify the type of natural gas savings which might be expected. (Tr. at 52-53). Staff asserts that Roanoke has not made an evidentiary demonstration that the advertisements benefit its ratepayers as contemplated by Virginia Code § 56-235.2. (Tr. at 53). Moreover, no cost benefit analysis has been provided, and the Commission has not approved the expenditures as part of a conservation or load management ("CLM") program. (Id.).

The Company's witness Williamson identified two different types of cooperative advertising. First, the Company advertises in conjunction with local developers about the availability of natural gas in certain subdivisions. (Ex. JBW-6, at 12). The Company asserts that its cooperative advertisements are not designed primarily to promote load growth, but to increase awareness of the value of natural gas. The Company argues that since the load already exists, the advertisements merely help ensure that the facilities are fully utilized. (Id. at 12-13).

In addition, $5,093 of the disallowed expense was spent in advertising sponsored by a consortium of Virginia natural gas companies. Mr. Williamson testified that the consortium advertisements promote the environmental benefits of natural gas, efficiency of natural gas vehicles, and Triathlon natural gas heat pumps. (Tr. 34).

On brief, the Company acknowledges that it did not obtain prior Commission approval for the advertisements at issue; however, it notes that it is important to remember that not all advertisements must comply with the strict testing and approvals of the Commission's Order on CLM programs. *Commonwealth of Virginia, At the relation of the State Corporation Commission Ex Parte: In re, Investigation of Conservation and Load Management Programs,* Case No. PUE900070, 1992 S.C.C. Ann. Rep. 261 (hereinafter "CLM Order"). "The strictures of the CLM Order only apply to advertising for cost effective CLM programs." (Company Brief at 24). The Company notes that its advertisements are not part of a CLM program. The Company asserts that its programs, however, are in the public interest.

Roanoke also asserts that its main extension policy requires a feasibility study before service lines and mains are extended. After such lines are placed in service, the Company must do what it needs to do to assure that the expected revenues will be generated from service along the extension.

Staff notes that Roanoke's name does not even appear on some of the consortium advertisements. (Tr. at 88). Section III.A(2) of the Rules Governing Utility Promotional Allowances allows a utility to jointly advertise with others, "if the utility is prominently identified as a sponsor of the advertisement. . ." (CLM Order, Attachment A). Review of the examples of such

advertisements admitted into the record reveals that Roanoke is not identified as a sponsor of the advertisement in one of the ads. (Ex. JBW-10).

Recovery of cooperative advertising costs has been debated for over five years. In one rate case, Appalachian Power Company, much as Roanoke in this case, argued that its cooperative advertising was not part of a CLM program and therefore the recovery of advertising expenses should not be evaluated based on the criteria of recovery of CLM expenses. *Application of Appalachian Power Company, for an expedited increase in rates,* Case No. PUE940063, Hearing Examiner Report at 17 (March 28, 1996). Therein I concluded that the statutory provision for recovery of advertising only allows "advertisements which solely promote the public interest, conservation or more efficient use of energy." (Va. Code § 56-235.2). Thus the statutory standard precluded recovery of advertising costs on a stand-alone basis unless the advertising "solely" promotes the public interest, energy efficiency or conservation. Any advertising which promotes load growth in any respect must be carefully reviewed.

> To the extent that an advertising cost is associated with a conservation or load management program, those costs should be included in the cost/benefit analysis performed in accordance with the Commission's directives in its CLM orders. [Citations omitted]. . . Certainly not all advertising will or must be associated with a CLM program, but absent such an association and analysis, advertising must otherwise meet a very stringent statutory standard. That heavy burden must, as always, be borne by the applicant.

(Report at 18). The Commission agreed, and disallowed those expenses. *Application of Appalachian Power Company,* Case No. PUE940063, 1996 S.C.C. Ann. Rep. 255.

Recently, the Commission disallowed the cooperative advertising costs of Virginia Natural Gas finding that the programs are "not required by 'law or rule or regulation' nor do they 'solely promote the public interest, conservation or more efficient use of energy;. . . " After reviewing specific examples of the advertising the Commission concluded they were "targeted at new potential natural gas loads and provide little information about efficiency or gas conservation." The Commission went on to state that:

> [t]he plain thrust of the advertisement is to increase the Company's natural gas load, not to "solely" promote the public interest, conservation, or more efficient use of energy.
>
> This and other VNG advertisements offered as typical advertisements for the EEH and QGC Programs do not apprise the public about how natural gas can be conserved or what specific energy efficient measures existing homeowners may undertake to conserve their gas usage.

Application of Virginia Natural Gas, Inc., Case No. PUE960227, slip op. at 5-7 (April 27, 1998).

Here, Roanoke specifically states that the advertising programs at issue are not part of a CLM program. Cost recovery for advertising that is not part of a promotional allowance or associated with a CLM program must then be governed solely by the statutory standard. Advertising that is neither a promotional allowance, nor otherwise part of a CLM program, is governed by the strict standards set forth in the Code and will only be allowed if it is "solely" designed to promote the public interest, conservation, and more efficient use of energy. If such advertising serves to promote load growth in any way, the costs of the program cannot be recovered. Hence, if the Company seeks recovery of advertising costs under the strict standard of the statute, it must be denied if there is any promotional aspect. Staff concluded that there were promotional aspects of the advertisements. I agree. Moreover, the Company does not deny the promotional nature of the advertising at issue, arguing instead only that there are also public benefits which can be gained. The Company's advertising costs related to its cooperative advertising programs thus should be disallowed under the strict standards set forth in the Code.

6. Office space expense

The Company has a Gas Information Center room consisting of 158 square feet, where it allows unregulated and unaffiliated manufacturers to display brochures advertising products which consume natural gas. Staff removed $16,570 from plant related to that space. (Ex. SCA-12, at 19). Staff also removed $4,385 of accumulated depreciation associated with the Gas Information Center. Staff witness Armstrong testified that although there are a few safety-related brochures displayed in this space, the majority is used to promote the natural gas products of nonregulated manufacturers. (Id.). Those products include, for instance, hot water heaters and gas heat pump appliances. (Tr. at 60). Roanoke itself does not market appliances. (Id.). Staff witness Armstrong testified that this space is similar to promotional advertising for nonregulated vendors and manufacturers. (Tr. at 142). Staff argues that the utility has the burden to show that an expense it seeks is just and reasonable and necessary to provide regulated service. Staff further asserts that office space devoted to advertising nonregulated products is not an investment necessary to provide the regulated natural gas distribution service; and therefore, should not be included in rate base. Customers, Staff observes, can get information about the products from sources other than the Gas Information Center. (Tr. at 60).

The Company, however, asserts that it has collected the information together in one location as a service to its ratepayers. Although it recognizes that some of the information is available from other sources, the Company believes that it is the natural and logical source for the information. (Tr. at 61). The space is thus provided as a customer service. (Ex. JBW-6, at 15). The Company asserts that the beneficiaries are clearly the ratepayers who gain expanded access to useful information. Since the Company does not conduct merchandising operations there should be no question of cross-subsidization of its own nonregulated business. (Tr. at 132).

The test, of course, for determining whether property should be included in rate base is whether it is used and useful in rendering regulated service. *Howell v. C&P Telephone*, 215 Va. 549, 558 (1975). While the Company acknowledges that the Center may not be essential to the distribution of natural gas service, it is used and useful to ratepayers who want information on use of their natural gas. The Center provides an added benefit to customers without incurring substantial additional cost to the Company. The Center allows customers to do their own research. (Ex. JBW-

6, at 15-16). I agree that it is in the customers' interest to have a collection place for materials related to natural gas use that may respond to questions customers are likely to ask Company personnel. The amount of space in the main office devoted to this customer service is small and therefore should not be excluded from rate base.

7. Cost of equity

Currently, Roanoke's authorized range for its cost of equity is 11.20% to 12.20%. *Application of Roanoke Gas Company*, Case No. PUE940039, 1995 S.C.C. Ann. Rep. 304. Staff witness Mary Owens testified that conditions in the financial market have changed since the time of the Company's last general rate case and thus warrant evaluation of the current authorized return on equity. Ms. Owens used a Discounted Cash Flow ("DCF") analysis based on a proxy group of sixteen gas distribution companies and a second smaller group consisting of six comparable companies. (Ex. MEO-16, at 1 and 11). Ms. Owens also used several risk premium analyses, including the Capital Asset Pricing Model ("CAPM") to derive her cost of equity estimates. The Company generally does not challenge the Staff's methodology. However, the Company criticizes Staff's use of a proxy group without recognizing the Company's greater level of risk. Specifically, the Company asserts that its risk profile is higher than the companies that make up the proxy group. The Company asserts that for the comparison to be valid, the financial values of the company being compared to the proxy group should fall inside the range of values for the proxy group. Mr. Williamson argues that the Company's financial risk factors are greater than those of the proxy group. (Ex. JBW-6, at 28-36). Mr. Williamson particularly notes a significant variance in factors such as liquidity and stock price, company size, debt rating and volatility of earnings. (Id. at 28-29). Mr. Williamson also notes that the Company's capitalization is substantially smaller than that of the proxy group. (Id. at 31).

The Company asserts that its debt rating is lower than that of the proxy group companies, noting that each of the six proxy companies have Standard and Poor's ("S&P") debt ratings of A or A-. (Ex. JBW-6, at 32). Wheat First Butcher Singer reported that if Roanoke had attempted a public offering of bonds, the offering would be rated in the BB category by S&P and Moody's, but also noted that a private placement of Senior Notes had received an NAIC 2 rating by the National Association of Insurance Commissioners ("NAIC"). (Ex. JBW-6, App. 7). Ms. Owens testified that the NAIC rating corresponded to an S&P rating of BBB. (Tr. at 151). A BBB rating is considered investment grade. (Id.). Moreover, two other Virginia utilities have S&P debt ratings in the BBB category. Those utilities would be United Cities with a BBB+ rating and Commonwealth Gas Services with a current rating of BBB. United Cities' authorized range is 10.5% to 11.5% and Commonwealth's range is 10.1% - 11.1%. (Id.).

Mr. Williamson also observes that a significant portion of the volatility in earnings of gas companies comes from changes in the weather. Five of the proxy group companies have implemented normalization clauses or automatic weather adjustments to their rates to smooth out the income from year to year and thus decrease the volatility of earnings. (Ex. JBW-6, at 33). The Company does not have a weather adjustment and has not requested one in this case. The Company notes that whether or not such a clause is requested, the level of risk the Company bears in earnings volatility is higher because it does not have such a clause. The Company asserts that it should receive a risk premium to reflect the actual level of risk which it faces. The Company asserts that a

risk premium of 50 basis points would compensate it for the lower cost of equity shown by the proxy group.

The Company derived its 50 basis point adjustment by first comparing the average dividend yield of the proxy group (5.2%) with the yield from the Company's dividend (6.2%). Mr. Williamson supports only a 50 basis point adjustment because other risk adjustments awarded by the Commission have ranged no more than fifty basis points and the Company's requested cost of equity range in this case is 11.2% - 12.2%. Mr. Williamson testified that a 50 basis point adjustment "carried us back to the number we had filed." (Tr. at 81). He concluded that a fifty basis point risk adjustment would adequately reflect the increased cost of equity faced by the Company.

The Edwards Jones financial information attached to Mr. Williamson's rebuttal testimony (Ex. JBW-6, App. 5 at 3-4), however, shows balance sheet data revealing that Roanoke's equity ratio is in line with that of the small proxy group. Roanoke's 50% equity ratio is comparable to that of the six small proxy group companies which range from 49% - 52%. (Tr. at 76-79).

Staff witness Owens also explained that Roanoke has unique strengths as compared to the proxy group, such as a strong economy and growth in its service territory. Some of the proxy companies have experienced weaker economies and less growth. Ms. Owens noted that there were also supply concerns with one or two of the proxy companies, but not for Roanoke. (Tr. at 157-158).

The Commission awarded Roanoke a 25 basis point risk adjustment in 1990. *Application of Roanoke Gas Company*, Case No, PUE890055, 1990 S.C.C. Ann. Rep. 291. Similarly, the Commission awarded a risk premium adjustment to Commonwealth Public Service Corporation of 50 basis points. *Application of Commonwealth Public Service Corporation*, Case No. PUE870034, 1987 S.C.C. Ann. Rep. 289. The Commission, however, has also rejected such adjustments when a company has not presented evidence that its size has created problems raising capital. (Tr. at 148). Staff argues that the Commission's recent precedent does not support a request for a small company adjustment. Notably, Roanoke has not received such an adjustment in any case since the 1989 case, and Commonwealth Public Service Corporation has not received a small firm risk adjustment subsequent to the 1987 case. (Tr. at 75-76). In a more recent case for Virginia-American Water Company, the Hearing Examiner recited the criteria for a small firm risk adjustment to require a showing of negative growth in the service territory or difficulty raising capital. Since Virginia-American Water Company presented no evidence to indicate its size caused any difficulty raising capital, an adjustment was found to be unwarranted. *Application of Virginia-American Water Company*, Case No. PUE950003, Report of Howard Anderson (December 13, 1996). Roanoke has not presented evidence to support either criteria in this case, hence I must conclude no adjustment is necessary.

Staff recommends that the Company's cost of equity be reduced from the range of 11.20% to 12.20% to a range of 10.7% to 11.7%. Based on the record herein, Staff's methodology is sound, the proxy group is comparable to Roanoke, and a reasonable range for the return on equity of the Company is 10.70% to 11.70%. I find Staff's recommendation is reasonable and supported by the record.

REVENUE REQUIREMENT

Based on my resolution of the issues discussed above and my acceptance of the other accounting and cost of capital issues that were not in dispute, Roanoke's additional revenue requirement is $260,432, as calculated below:

Roanoke Gas Company
Revenue Requirement per Hearing Examiner

Adjusted Net Operating Income per Armstrong Statement II (Exhibit SCA-14)	$ 3,489,169
To restore the amortization of the retired gas manufacturing plant	$ 22,086
To reflect FIT effect of changes	(7,711)
Adjusted Operating Income per Examiner	$ 3,474,794
Rate Base per Armstrong Statement II (Exhibit SCA-14)	$37,671,128
To add back office space for Gas Information Center	$ 12,185
Rate Base per Hearing Examiner	$37,683,313
Overall cost of capital with 11.20% ROE	9.663%
Adjusted Operating Income Required	$ 3,641,293
Adjusted Operating Income per Examiner	$ 3,474,794
Net Required	$ 166,499
Revenue Conversion Factor	÷ 63.93185%
Gross Revenue Requirement per Examiner	$ 260,432

A revised rate of return statement is attached hereto. (Attachment D).

FINDINGS AND RECOMMENDATIONS

In conclusion, based on the evidence received in this case, and for the reasons set forth above, I find that:

1. The use of a test year ending September 30, 1996, is proper in this proceeding;

2. The Company's test year operating revenues, after all adjustments, were $48,263,533;

3. The Company's test year operating expenses, after all adjustments, were $44,749,080;

4. The Company's test year operating income and adjusted operating income, after all adjustments, were $3,514,452 and $3,474,794, respectively;

5. The Company's adjusted test period rate base, updated to March 31, 1997, is $37,683,313;

6. The Company's current rates produced a return on adjusted rate base of 9.221% and a return on equity of 10.150%;

7. The Company's cost of equity is within a range of 10.70% to 11.70%, and rates should be established at the midpoint of that range, 11.20%;

8. The Company's current rates are unjust and unreasonable because they will generate a return on rate base of only 9.221%;

9. The Company's requested increase in rates is not just and reasonable based on the reasons set forth above;

10. The Company requires an increase in gross annual revenues of $260,432 to earn a 9.663% return on rate base;

11. The Company should file permanent rates designed to produce the additional revenues found reasonable herein effective January 1, 1997, to be consistent with Staff's revenue apportionment. The final increase in revenues should be distributed on an equal percentage basis to each volumetric rate block within the rate schedule;

12. The Company should be required to refund, with interest, all revenues collected under interim rates in excess of the amount found just and reasonable herein;

13. The Company should credit the expense accounts originally charged when billing affiliated companies for management services, accounting and billing, rather than recording management fees as revenues; and

14. As recommended by Staff, the Company should capitalize several items, totaling $75,527, which had been expensed by the Company. The Company should book a credit to the appropriate operations and maintenance expense accounts in the current period with a debit to the appropriate asset accounts as agreed to by Company witness Williamson.

In accordance with the above findings, ***I RECOMMEND*** that the Commission enter an order that:

1. ***ADOPTS*** the findings in this Report;

2. ***INCREASES*** the Company's authorized gross annual revenues by $260,432; and

3. ***DIRECTS*** the refund with interest of all amounts collected under the interim rates in excess of the rate level found just and reasonable herein.

COMMENTS

The parties are advised that any comments (Section 12.1-31 of the Code of Virginia and Commission Rule 5:16(e)) to this Report must be filed with the Clerk of the Commission in writing, in an original and fifteen (15) copies, within fifteen (15) days from the date hereof. The mailing address to which any such filing must be sent is Document Control Center, P. O. Box 2118, Richmond, Virginia 23218. Any party filing such comments shall attach a certificate to the foot of such document certifying that copies have been mailed or delivered to all other counsel of record and to any party not represented by counsel.

Respectfully submitted,

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Deborah V. Ellenberg
Chief Hearing Examiner